

# Reserves Management

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2020 was a year full of unexpected twists and turns, as the COVID-19 pandemic brought unprecedented challenges to the global economy. Asset markets experienced major corrections and disruptions in the first quarter of the year, after which sharp rebounds were recorded amid ultra-loose monetary policies put forth by major central banks and generous relief measures launched by various governments. Sovereign bond yields fell markedly while bond prices went up as major central banks substantially cut their benchmark interest rates and relaunched quantitative easing programmes. Against this backdrop, the Exchange Fund recorded an investment income of HK\$235.8 billion in 2020, representing an investment return of 5.3%.

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## Reserves Management

### THE EXCHANGE FUND

The Exchange Fund's primary objective, as laid down in the Exchange Fund Ordinance, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. The Fund may also be used to maintain the stability and integrity of Hong Kong's monetary and financial systems to help maintain Hong Kong as an international financial centre. The HKMA, under the delegated authority of the Financial Secretary (FS) and within the terms of the delegation, is responsible to the FS for the use and investment management of the Exchange Fund.

### MANAGEMENT OF THE EXCHANGE FUND

#### Investment objectives and portfolio structure

The Exchange Fund Advisory Committee (EFAC) has set the following investment objectives for the Exchange Fund:

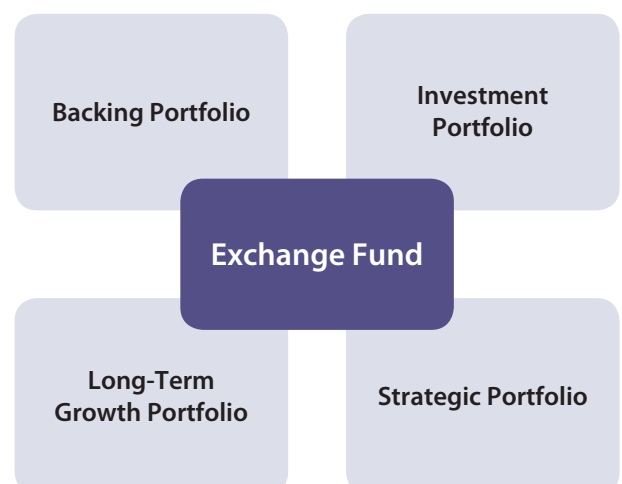
- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base, at all times, is fully backed by highly liquid US dollar-denominated assets;
- (c) to ensure that sufficient liquidity is available for the purposes of maintaining monetary and financial stability; and
- (d) subject to (a)–(c), to achieve an investment return that will help preserve the long-term purchasing power of the Fund.

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the portfolio structure and the target asset mix of the Fund.

Broadly speaking, the Exchange Fund has two major portfolios: the Backing Portfolio (BP) and the Investment Portfolio (IP). The BP holds highly liquid US dollar-denominated assets to provide full backing to the Monetary Base as required under the Currency Board arrangements. The IP invests primarily in the bond and equity markets of the member countries of the Organisation for Economic Co-operation and Development to preserve the value and long-term purchasing power of its assets.

To better manage risks and enhance returns in the medium and long term, the HKMA diversifies part of the Exchange Fund's investments in a prudent and incremental manner into a wider variety of asset classes. This includes emerging market and Mainland bonds and equities, private equity (including infrastructure), and real estate. Emerging market and Mainland bonds and equities are held under the IP, while private equity and real estate investments are held under the Long-Term Growth Portfolio (LTGP). The cap for the market value of investments under the LTGP is set at the aggregate of one-third of the accumulated surplus of the Exchange Fund, and the portion of placements by the Future Fund and subsidiaries of the Exchange Fund linked to the LTGP.

The Strategic Portfolio, established in 2007, holds shares in Hong Kong Exchanges and Clearing Limited that have been acquired by the Government for the account of the Exchange Fund for strategic purposes. This Portfolio is not included in the assessment of the Fund's investment performance because of its unique nature.



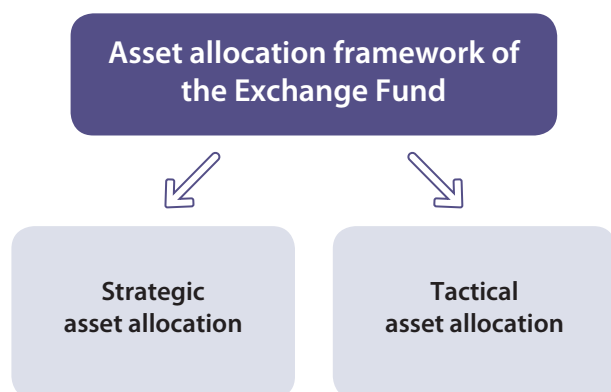
## Reserves Management

### Placements with the Exchange Fund

The Exchange Fund, from time to time, accepts placements by Fiscal Reserves, Government funds and statutory bodies. The interest rate is generally linked to the performance of the IP<sup>1</sup>, with the major exception of the Future Fund, which links its interest rate to both the IP and the LTGP with reference to the portfolio mix. The portfolio mix of the Future Fund between the IP and the LTGP is about 40:60.

### The investment process

The investment process of the Exchange Fund is underpinned by decisions on two types of asset allocation: the strategic asset allocation and the tactical asset allocation. The strategic asset allocation, reflected in the investment benchmark, represents long-term asset allocation given the investment objectives of the Exchange Fund. Guided by the strategic allocation, assets are tactically allocated in an attempt to achieve an excess return over the benchmark. This means the actual allocation is often different from the benchmark (or strategic) allocation. The differences between the actual and benchmark allocations are known as “tactical deviations”. While the benchmark and tracking error<sup>2</sup> limit are determined by the FS in consultation with the EFAC, tactical decisions and allowable ranges for tactical deviations are made and set by the HKMA under delegated authority. Within the ranges allowed for tactical deviations, portfolio managers may assume positions to take advantage of short-term market movements.



### Investment management

#### Direct investment

The HKMA's Exchange Fund Investment Office (EFIO) houses its investment and related risk management functions. EFIO staff members directly manage about 72% of the investments of the Exchange Fund, comprising the entire BP and part of the IP. This part of the IP includes a set of portfolios invested in global fixed-income markets and various derivative overlay portfolios implementing macro risk management strategies for the Fund.

#### Use of external managers

In addition to managing assets internally, the HKMA employs external fund managers to manage about 28% of the Exchange Fund's assets, including all of its listed equity portfolios and other specialised asset classes. The purpose of engaging external managers is to tap the best investment expertise available in the market to realise sustainable returns, draw on diverse and complementary investment styles, and gain their market insights and technical expertise in investment.

Expenditure relating to the use of external managers includes fund management and custodian fees, transaction costs, and withholding and other taxes. The expenditure is determined primarily by market factors and may fluctuate from year to year.

#### Risk management and compliance

The growing complexity of the investment environment underlines the importance of risk management. The HKMA sets stringent controls and investment guidelines for both internally and externally managed portfolios, and ensures a proper risk monitoring and compliance system is in place. Three lines of defence exist to implement effective risk management and governance of investment-related activities. Key risk categories (including credit, market, liquidity and operational risks) are regularly monitored and the risk management process has been strengthened to support investment diversification.

<sup>1</sup> The rate is the average annual investment return of the IP for the past six years, or the average annual yield of three-year Government Bond for the previous year subject to a minimum of 0%, whichever is higher.

<sup>2</sup> "Tracking error" measures how closely a portfolio follows its benchmark.

## Reserves Management

### Responsible Investment (RI)



The HKMA supports RI by integrating environmental, social and governance (ESG) factors into the investment process for both public and private market investments of the Exchange Fund.

A set of principles is in place to evaluate ESG risks and opportunities in the Exchange Fund's investments. For portfolios managed by external managers, RI is carried out through the appointed managers. To select, appoint and monitor external managers, the HKMA assesses different aspects of their ESG implementation, including their organisational setup with respect to ESG governance, ESG standards and policies, integration of ESG factors into investment processes, and stewardship activities including proxy voting and their portfolio company engagement programme, i.e. their discussion with management of portfolio companies on ESG issues. The HKMA emphasises RI by promoting better ESG practices in the external managers' stewardship activities. External managers of the HKMA's Hong Kong and Mainland active equities are required to commit to the Principles of Responsible Ownership issued by the Securities and Futures Commission on a "comply-or-explain" basis. The HKMA's external managers of developed market equities portfolios need to adhere to generally accepted international ESG standards. In addition, the HKMA has initiated a post-appointment monitoring programme to review the proxy voting and portfolio company engagement activities of its external managers.

The HKMA's internally managed fixed-income portfolio incorporates ESG factors into the credit risk analysis of bond investment. Analysis is strengthened by expanding the sources of ESG data and assigning greater weight to ESG factors in the quantitative assessment.

For ESG investments in the public market, the HKMA has been investing in green, social and sustainability bonds ("ESG bonds") since 2015. The HKMA is one of the early investors in this market, and participates in the Managed Co-Lending Portfolio Program run by the International Finance Corporation with a focus on sustainable investments across emerging markets. In 2020, the HKMA increased its investment in ESG bonds amid greater supply in the market. Going forward, the HKMA will continue to grow its ESG bond portfolio through direct purchase or

investing in ESG bond funds. It will also motivate external managers to invest in ESG-themed equity mandates by adopting an ESG equities index as a benchmark for passive portfolios. In the coming years, the HKMA will continue to explore ESG-themed investment opportunities, such as active ESG mandates and low-carbon investment themes.

In private market investments, the HKMA examines the ESG policies and practices of general partners (GPs) as part of due diligence. The LTGP under the HKMA invests proactively in projects with sustainable features, including renewable energy infrastructure, as well as warehouses and other buildings with green and sustainable features in its real estate portfolio. Going forward, the HKMA will continue to source projects with sustainable features and include green accreditation as a key factor in real estate investment. The HKMA holds an annual ESG Workshop with GPs to share views and experiences on good ESG practices. At the ESG Workshop in November, GPs exchanged views about the impact of COVID-19 on their portfolio companies and the development of ESG investment. To improve the ESG transparency of private market investments, the HKMA has asked GPs to provide ESG information such as the climate change risks of its investments for monitoring purposes.

The HKMA will continue to monitor the development of ESG standards closely and assess how to further integrate these standards into its investment process. The process is facilitated by collaboration with like-minded investors and international organisations. In particular, the HKMA is a signatory of the UN-supported Principles for Responsible Investment, which is the world's leading proponent of RI, and expects to participate in formulating ESG best practices and to encourage other investors to adopt RI. The HKMA is also a member of the not-for-profit organisation, FCLTGlobal, which works to foster a longer-term focus in business and investment decision-making through workshops and research studies. The HKMA supports the Task Force on Climate-related Financial Disclosures and is a member of the Network of Central Banks and Supervisors for Greening the Financial System. In addition, the HKMA organises talks and actively participates in events held by the investment community to share and promote views on ESG investment.

For more details about the HKMA's RI policy framework, see the *Corporate Social Responsibility* chapter.

## Reserves Management

### PERFORMANCE OF THE EXCHANGE FUND

#### The financial markets in 2020

Global financial markets ended the year on a high note on the back of accommodative monetary and fiscal policies made in response to significant challenges posed by COVID-19 to the world economy. Equity markets around the world rebounded sharply, with double-digit growth in key markets, after experiencing major corrections and disruptions in the first quarter of the year. The Standard & Poor's 500 Index in the US rose by 16%, the best performing G7 equity index in 2020.

In the bond markets, yields of major developed countries remained suppressed after a significant decline in the first quarter. Ten-year US Treasury yields decreased by about 100 basis points from 1.9% at the beginning of the year to 0.9% at the end of the year. As major sovereign bond prices shot up, the mark-to-market gains in the bond markets were phenomenal in 2020.

In the currency markets, the US dollar weakened against other major currencies, particularly during the second half of 2020, as lower US interest rates narrowed interest rate gaps. In particular, the euro and the renminbi gained around 9.0% and 6.5% against the US dollar respectively.

The performance of major currency, bond and equity markets in 2020 is shown in Table 1.

**Table 1** 2020 market returns

#### Currencies

Appreciation (+)/depreciation (-) against US dollar

Euro	+9.0%
Pound	+3.2%
Renminbi	+6.5%
Japanese yen	+5.3%

#### Bond markets

Relevant US Government Bond (1–30 years) Index	+8.4%
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#### Equity markets<sup>1</sup>

Standard & Poor's 500 Index	+16.3%
DAX Index	+3.5%
FTSE 100 Index	-14.3%
TOPIX Index	+4.8%
MSCI Emerging Markets Index	+15.8%
Hang Seng Index	-3.4%

1. Market performance on equities is based on index price change during the year.

## Reserves Management

### The Exchange Fund's performance

The Exchange Fund recorded an investment income of HK\$235.8 billion in 2020. This comprised gains on bonds of HK\$92.7 billion, gains on Hong Kong equities of HK\$4.0 billion, gains on other equities of HK\$69.9 billion, a positive currency translation effect of HK\$9.6 billion on non-Hong Kong dollar assets and gains of HK\$59.6 billion on other investments held by the investment holding subsidiaries of the Fund. Separately, the Strategic Portfolio recorded a valuation gain of HK\$14.0 billion.

Total assets of the Exchange Fund reached HK\$4,499.2 billion at year-end. The market value of investments under the LTGP totalled HK\$406.4 billion, with private equity amounting to HK\$299.7 billion and real estate at HK\$106.7 billion. Outstanding investment commitments of the LTGP amounted to HK\$224.1 billion.

The investment return of the Exchange Fund in 2020, excluding the Strategic Portfolio, was 5.3%. Specifically, the IP achieved a rate of return of 7.8%, while the BP gained 1.6%. The LTGP has recorded an annualised internal rate of return of 13.7% since its inception in 2009.

The annual returns of the Fund from 1994 to 2020 are set out in Chart 1. Table 2 shows the 2020 investment return and the average investment returns of the Fund over several different time horizons. The average return was 4.0% over the past three years, 4.3% over the past five years, 3.0% over the past 10 years and 4.8% since 1994<sup>3</sup>. Table 3 shows the currency mix of the Fund's assets on 31 December 2020.

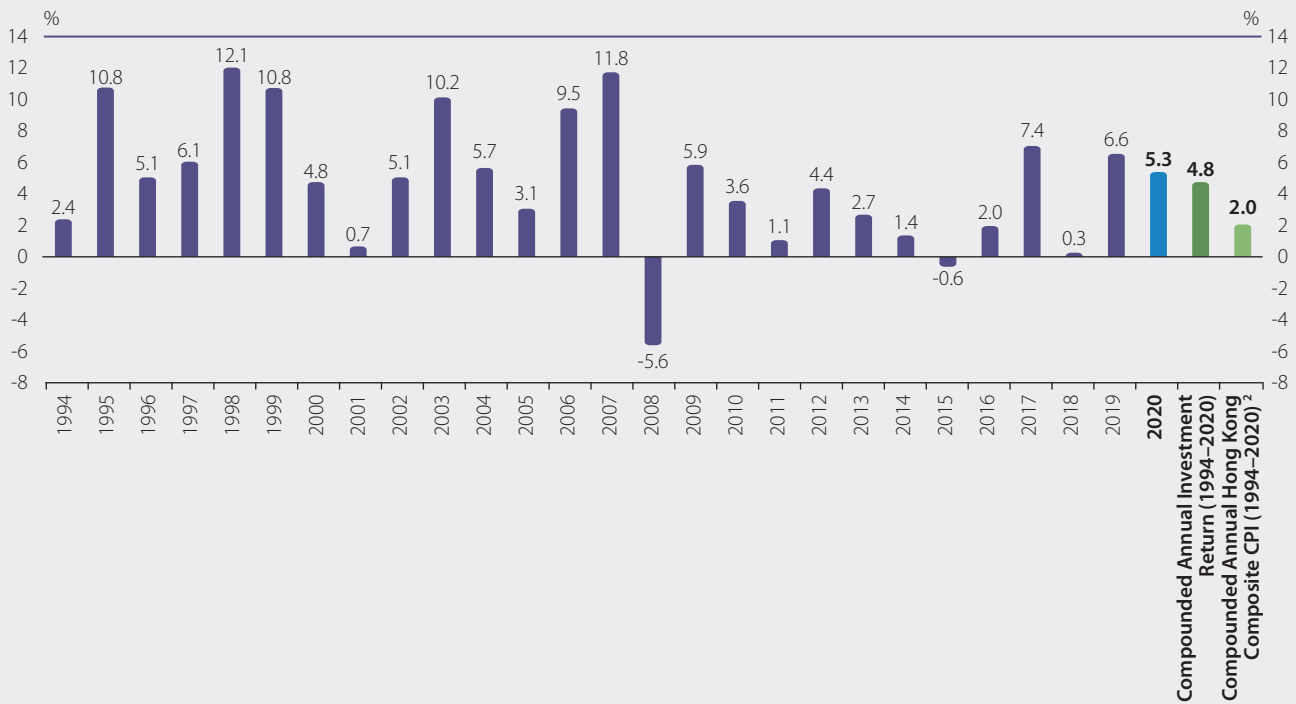


*HKMA Deputy Chief Executive, Mr Howard Lee, speaks at the press conference on the Exchange Fund results for 2020.*

<sup>3</sup> Averages over different time horizons are calculated on an annually compounded basis.

## Reserves Management

**Chart 1** Investment return of the Exchange Fund (1994–2020)<sup>1</sup>



1. Investment return calculations exclude holdings in the Strategic Portfolio.
2. The Composite Consumer Price Index is calculated based on the 2014/2015-based series.

## Reserves Management

**Table 2** Investment return of the Exchange Fund in Hong Kong dollar terms<sup>1</sup>

	Investment return <sup>2&amp;3</sup>
<b>2020</b>	<b>5.3%</b>
3-year average (2018–2020)	4.0%
5-year average (2016–2020)	4.3%
10-year average (2011–2020)	3.0%
Average since 1994	4.8%

1. The investment returns for 2001 to 2003 are in US dollar terms.
2. Investment return calculations exclude holdings in the Strategic Portfolio.
3. Averages over different time horizons are calculated on an annually compounded basis.

**Table 3** Currency mix of the Exchange Fund's assets on 31 December 2020 (including forward transactions)

	HK\$ billion	%
US dollar	3,829.1	85.1
Hong Kong dollar	221.0	4.9
Others <sup>1</sup>	449.1	10.0
<b>Total</b>	<b>4,499.2</b>	<b>100.0</b>

1. Other currencies consisted mainly of the euro, renminbi, pound sterling and Japanese yen.